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Champion
Champion International Corporation

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February 28, 2000

Surface Transportation Board
Office of the Secretary
Case Control Unit
1925 K Street, N.W.
Washington, D.C. 20423-0001

re: STB Ex Parte 582
Public Views on Major Rail Consolidations

Dear Mr. Secretary:

Enclosed please find the original and ten (10) copies of the statement of Champion International Corporation in STB Ex Parte 582, *Public Views on Major Rail Consolidations* in accordance with the Decision dated February 16, 2000. Also enclosed is a 3.5 inch diskette in WordPerfect 5.1 format which is convertible to WordPerfect 7.0.

Champion is scheduled to appear and offer oral comments to the Board on Thursday, March 9, 2000 along with other lumber and paper companies and associations. Champion's representative (speaker) for the oral hearing will be Richard E. Kerth, Transportation Manager-Commerce & Regulatory Affairs.

Champion respectfully requests that admission badges for the March 9th hearing be placed in the names of: Richard E. Kerth (speaker) and Kim Wirth, Government Affairs Manager for Champion.

We look forward to our dialogue with the Board on this matter.

Sincerely,

Richard E. Kerth

Richard E. Kerth

cc: K. Wirth

COMMENTS

OF

CHAMPION INTERNATIONAL CORPORATION

BEFORE THE

SURFACE TRANSPORTATION BOARD

EX PARTE NO. 582

Public Views on Major Rail Consolidations

March 9, 2000

Submitted by:
Richard E. Kerth, Transportation Manager
Commerce & Regulatory Affairs
Champion International Corporation
101 Knightsbridge Drive
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BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE NO. 582

Public Views on Major Rail Consolidations

My name is Richard Kerth. I am Transportation Manager - Commerce and Regulatory Affairs for Champion International Corporation, an integrated forest products company with operations in the United States, Canada, and Brazil. Champion and our wholly-owned subsidiary, Weldwood of Canada (hereinafter collectively referred to as "Champion"), are major customers of railroads operating in the United States and Canada. In 1999, Champion shipped 40,000 rail cars of product throughout North America at a cost in excess of $100 million. Our industry group, forest products, is the fourth largest user of domestic U.S. railroad transportation , moving an average 24,000 carloads per week and accounts for approximately nine per cent (9%) of all rail revenues. Champion relies heavily upon the railroad industry for transportation of raw materials used in our products and for moving finished goods into the marketplace. We believe that rail competition, choice, and capacity are essential to Champion, our industry, and our nation in order to compete in the global economy.

Discussing our views on major railroad consolidation is not easy given the fact that Champion[1] and our industry are in the process of consolidation. The forest products industry, not unlike the railroad industry, recognizes that consolidation permits companies to reduce costs and become more efficient. The major difference between consolidation in our industry, as compared to the railroad industry, is the customer of a forest product industry consolidation has a *choice of provider* if a failure in supply should occur. Our customers are not captive to a single source of supply for the products and services we offer. Our marketplace is open to all qualified competitors –domestic and abroad. Consolidation has not reduced competition or limited options to our customers when compared to the rail industry.

Ex Parte 582: In this proceeding, the Board seeks public comment on a number of broad issues heightened by the recent announcement that Burlington Northern and Santa Fe Railway Co. and Canadian

[1] February 17, 2000 announcement that UPM-Kymmene OyJ (Finland) will buy U.S. rival Champion International Corporation for more than $6 billion (US) in the first major cross-Atlantic forest industry takeover.

National Railroad [2] will file an application seeking Board authorization to be brought under common control. Specific issues of concern include:

1. Timing - Should the U.S. Railroad industry concentrate on existing opportunities to improve service rather than further consolidation? Is the railroad industry still recovering from service disruptions associated with previous consolidations?
2. Strategic response - Will this consolidation lead to significant additional consolidation and other structural changes? Will this require change to the way the industry is regulated?
3. Public interest - Is consolidation good for large and small railroads? Customers? Employees? The public interest?
4. Financial aspect - What is the effect of railroad industry consolidation on the financial condition of the industry?
5. Service and Price - What will be the future ability of railroads to provide responsive service at reasonable prices?
6. Operational - Does the industry have the necessary infrastructure, capacity, and configuration to meet expanded demand for services now and in the future?

Champion offers these responses to those questions for the Board's consideration.

Timing: The Railroad Revitalization and Regulatory Reform Act of 1976[3] followed by the Staggers Rail Act of 1980 [4] provided the nation's railroads with flexibility to respond to market conditions and therefore compete for a greater share of the nation's traffic. Congress envisioned three goals from these legislative initiatives: (1) restoration of the railroad industry's financial health which, prior to the legislation's enactment, had been deteriorating for a number of years; (2) creation of competition; and (3) service improvement. The industry's financial health has improved significantly in the last two decades creating the financial ability for railroads to grow market share through consolidation. Yet, vigorous rail - to- rail competition as envisioned by Congress is virtually non-existent. Our experience is railroads tend to compete with one another only when two rail carriers provide service at the same origin or destination but not when the service is captive to one road. Overall service has not improved; customer satisfaction levels are at an all time low. Railroads are not easily held accountable for service failures. The railroad industry has not made good on its promise to pull freight off the highways because of the unsatisfactory service levels and non-competitive rates, particularly on captive traffic. Despite the current domestic economic expansion, railroads have not made investments needed to accommodate the expanding volume of traffic. In recent memory, infrastructure improvements appear to be more reactive rather than planned , e.g. direct results of service failures in Houston, the West, and the northeast.

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[2] Canadian National Railway Company, Grand Trunk Western Railroad Incorporated, Illinois Central Railroad Company, Burlington Northern Santa Fe Corporation, and the Burlington Northern Santa Fe Railway Company –Common Control, STB Finance Docket 33842

[3] Public Law 94-210

[4] Public Law 96-448

This scenario is particularly frustrating because the strong U.S. economy has created new opportunities for Champion to market its products both domestically and globally. Forest products are bulk products and are most efficiently transported by rail. New market opportunities are valid only if Champion can meet the customers' business need for 'consistent delivery of products at a reasonable price for the transportation.' These are not options. Our marketplace does not allow us to negotiate this term with our customers. For the last several years, rail service has stymied our ability to meet our customers' needs. Poor rail service has not allowed us to compete aggressively for new business in our marketplace because the network on which we are dependent has not performed satisfactorily.

The rail industry has not fully recovered from service problems that have plagued the network, attributable in large part to past mergers. Champion continues to experience service problems on a daily basis and has hired additional people to track and trace rail shipments to ensure our product is delivered in a timely manner. Unresolved service issues makes the timing of the BNSF/CN merger particularly troublesome. Railroads are a network. The western railroads would probably operate much better if not for the current service problems in the east; conversely, the eastern railroads would have operated better if not for the service problems experienced in the west a few years ago. When one examines the network ramifications that would result from another large merger, we believe the network is too fragile for another merger. The industry needs to resolve current service issues before new issues are created. The promised benefits from previous mergers should be realized before the railroad's further consolidate.

Strategic Response: As a result of previous consolidations, the current rail landscape in North America now includes "regional duopolies". Two railroads provide principle service in the east: Norfolk Southern ("NS") and CSX Transportation ("CSX") ; and, in the west, Union Pacific Southern Pacific ("UPSP") and Burlington Northern Santa Fe ("BNSF"). Between the north and south, Canadian National /Illinois Central ("CN/IC") competes on a limited basis with BNSF, UPSP, NS, and CSX depending on the region of the country. In Canada, the CN/IC competes principally with the Canadian Pacific ("CP") but that competition is very limited. The most recent announcement from CN and BNSF will change the landscape again. This begs the question: are we on the path for a "duopoly" where only two railroads will provide service, one between the east and west and one between the north and south, in all of North America ?

As a direct response to the recent BNSF and CN merger announcement, Champion believes the remaining industry will respond by additional parties announcing their intent to merge. History of the industry tells us that mergers lead to more mergers. CP will be surrounded by the proposed BNSF/CN railroad combination. BC Rail ("BCOL") in Canada has only one exclusive physical interchange: CN. Kansas City Southern Railway Co., Wisconsin Central Railroad, Springfield Terminal, and the Texas Mexican Railway Co., among others, are all vulnerable to consolidation because of their geographic position in the race for one or two major roads to become "transcontinental". Small railroads will need to merge with larger partners to stave off an attack on their markets and their very existence. Already, these smaller railroads are losing their pricing autonomy, evidenced by the larger road's efforts to do away with Rule 11[5] proportional rates. The regulatory system has judged past consolidations and publicly pronounced: "When carrier operations can be more efficient and less costly without disrupting essential services, it is in the public interest to approve the result. We will not artificially and unnecessarily restrict the action of the market place by placing too great an emphasis on the harm to individuals." This pronouncement leads us to conclude the regulatory system will not protect the remaining railroads or the industry's customers.

Public Interest: Recent railroad consolidations have created less predictable service with little or no accountability to the customer. We have experienced so much traffic on just a few railroads that when one system failed (as occurred with the Union Pacific -Southern Pacific merger and with CSX/NS acquisition of Conrail), the network failed and took customers dependent on rail service down with it. Shippers cannot easily go around service problems. Railroad consolidation leaves *customers with few choices.* As the railroad industry again looks to consolidation, shippers are left to wrestle with only three choices:

1. Do we *favor* further consolidation of the industry which may provide opportunity for lower cost (presumably from the efficiencies being translated into lower rates) in the short term? .. or,
2. Do we *oppose* further consolidation and promote the use of competition as a primary determinant for improving service, creating alternatives, and setting rail prices?, ..or,
3. Do we favor an economic *re- regulation* of the industry?

Our experience of poor service coupled with the inadequacy of the current regulatory system to promote competition makes our choice clear. **Competition must be realized before future consolidation.** We must put the needs of our customers who demand consistent, dependable rail service at a fair price ahead of the needs of a railroad industry which has failed to deliver on its past promises. Service must improve and service must be consistent. Competition, choice, and capacity are public interest requirements. Governmental policy towards railroads should maximize rail-to-rail competition and rely on the free market to encourage service improvements, stimulate innovation, and protect consumers. Where consolidation threatens these principles, consolidation should not be permitted.

Throughout the twentieth century, the federal government has encouraged mergers of carriers into strong systems through legislation, including the Transportation Act of 1920, the Prince Plan of the 1930s,

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[5] Accounting Rule 11 allows a shipper to seek a quote for its traffic from origin to an interchange at which point the shipper contracts directly with the connecting carrier for a rate from the interchange point to another interchange or the final destination. Each carrier is paid separately for its services and does not have knowledge of the other's rate.

and the Staggers Rail Act of 1980. During the late 1950s, our nation experienced a rash of mergers that led Northern Pacific's CEO Robert S. McFarland to predict the nation's railroads would be merged into "perhaps 25 great systems" within fifteen or twenty years. McFarland's prediction came to fruition in the 1960's and early 1970's. We can only speculate if McFarland had envisioned that only two rail systems operating in all of North America would be a distinct possibility in the 21st century. The railroad's principle argument for consolidation in the 1950s is the same argument we hear 50 years later -- it is " a matter of survival." We don't believe "survival" is the issue now or for the future. Rather, we believe the merger entities are seeking undue market power and market share. The likely result will be limited capacity, stifled innovation, and service that is not responsive to the customer's needs.

Lest we forget, the nation's first transcontinental railroad was actually two railroads –the Central Pacific and Union Pacific who joined rails on May 10, 1869 at Promontory, which later became the state of Utah. The Pacific Railroad Act of 1862 and a similar act in 1864 authorized governmental support for two private companies to work cooperatively to build the continuous line available for "the business and necessities of the American people". One hundred and thirty one years later, the iron rail infrastructure is in place. The spirit of cooperation, collaboration, and competition of that era is all but gone. Today, each railroad owns its infrastructure and has the market power to determine what products move over its lines, the quantities (by controlling equipment) and, ultimately, the price for the transportation service.

The public interest would be better served by a renewal of the spirit of cooperation, collaboration and competition and not consolidation.

Financial Aspect, Service and Price, and Operations: In our judgment, these issues are tightly woven together. There is no question that railroads need to earn a fair rate of return to maintain their current infrastructure safely and efficiently but also to expand their services in response to customer need. We are concerned that railroads will use their market power to extract rates that far exceed their variable and fixed costs because so many shippers are captive to a rail system that does not have rail-to-rail competition or meaningful competition from other modes.

Escalation Consultants[6] did a study, albeit pre- NS/CSX acquisition of Conrail in 1999[7], which indicated that some railroads already have overwhelming market power. We quote: "The study indicated that Class I railroads physically have the ability to insulate many of their receivers from producers located on other railroad lines. The analysis further indicated that it is virtually impossible to ship some commodities to any plant on a railroad's system if the commodity does not originate on the railroad's

[6] Escalation Consultants, Inc. 4 Professional Drive, Suite 129, Gaithersburg, MD 20879
[7] Rail Price Advisor publication , Fourth Quarter, 1999 Volume 8 No. 4 published by Escalation Consultants, Inc.

system." Escalation Consultants developed a "Market Protection Ratio" that is the 'sum of all tons that both originate and terminate on a railroad divided by the total tons that terminate on a railroad.' The ratio indicates the ability of a railroad to keep those products that do not originate on its lines out of its receiver's plants, i.e. keep single line traffic on its line. "The higher the market protection ratio, the greater its success in protecting the transportation markets." The study looked at farm products, coal, food, lumber, chemicals, petroleum and coal products, metals and scrap materials. The analysis indicated CSX Transportation currently has a 98.2% ratio; BNSF a 87.1% ratio, UP an 81.8% ratio, NS a 77.7%, Conrail a 66.3% ratio, and KCS a 32.8% ratio. As consolidation continues, railroads will continue to increase the number of producers and purchasers of commodities captive to their lines. Market power will continue unchecked.

Bob Delaney, Sr. Vice President of Cass Logistics said in his 1998 State of Logistics address: "Rail market power has become more concentrated than at any time during the 20th century. Service has become more problematic than at any time since World War I." For these reasons, Champion would encourage the Board to consider the Escalation Consultants model or a similar model to better gauge and understand the power that the railroad industry has over the marketplace. A gain in railroad efficiency resulting from consolidation, and not coupled with consistent, customer "acceptable" service at a fair price, is clearly not in the public interest.

Champion believes that competition is the hallmark that drives improvements in service and constrains price (rates). Under current law, market dominance can be found if a railroad faces no effective competition and the revenue to variable cost ratio for the traffic exceeds 180 per cent. This formula may have been appropriate when the nation had 50 railroads with revenues in excess of $10 million dollars annually. We suggest that this formula is no longer appropriate as 5 railroads generate more than 94% of the U.S. domestic industry's revenues; own over 90% of the track miles; and control 90% of coal movements; 70% of grain movements; and 88% of chemical movements.

We have reached a time when legislative and regulatory change is required to protect the consumer and the public interest . Congress gave the Board tools to protect individuals from harm. While we respect the Board's difficult position between the intent of Congress and the public interest, we believe the Board needs to fundamentally increase its use of its conditioning authority to expand or maintain competitive options for shippers. Until such time as Congress acts on the bigger landscape issue, we encourage the Board to use its conditioning authority to a higher degree to protect individuals. We further believe it to be in the public interest for the Board to work cooperatively with the governments of Canada and Mexico as it examines the anti-competitive effects of future consolidation in the rail industry in North America.

The initial projected benefits[8] to be gained by the consolidation of CN and BNSF lead us to believe mergers are not required to achieve that level of return. Railroads can achieve the same benefits by forming consortiums to purchase energy, locomotives, and other equipment using the industry's collective bargaining power. Railroads do not have the interchange problems to the same extent they had 10 or 15 years ago; previous consolidations have eliminated many of those problems. Railroads have the ability to talk and plan their way through interchange issues similar to the current project underway in Chicago. If railroads choose the cooperative and collaborative spirit, they can accomplish many of the same benefits without a merger.

Summary: Champion must meet the needs of our customer or the customer will purchase products from our competitors. The forest products industry must meet the needs of its customer or the forest products industry will cease to exist. Should the forest products industry not be able to compete in its markets, a substantial piece of the railroad industry does not need to exist. The railroad industry needs to understand the needs of its customers. Over the past several years, the Board helped to establish the Rail Customer Forums in order to create a dialogue between the parties. The customers have told the railroads of their need for competition and service; yet, the railroad industry still has not gotten the message. The railroads remain focused inward and not on their customers. Further consolidation is a blatant example of this inward focus.

Shippers want vigorous competition within the rail industry and railroads with other modes of transportation. Shippers also want railroads to earn a fair, honest economical return in order that they might continuously invest, improve, and maintain the infrastructure. Competition within the rail industry will require more than two eventual large players. Small railroads, stripped of their ability to make rates and interchange traffic, is not competition. In summary,

1. Competition must be paramount to further consolidation in the industry.
2. Rail competition, choice, and capacity are essential if Champion, our industry, and our nation are to be able to compete in the global economy.
3. Until Congress re-examines the landscape post consolidation that has occurred in the rail industry, we encourage the Board to increase its conditioning authority to protect individuals.
4. We urge the Board to consider the Escalation Consultants or a similar model to gauge railroad market power.
5. We urge the Board to fashion a renewal of commercial relationships that include cooperation, collaboration, and competition among the railroads as an alternate to merger.

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[8] CN /BNSF Press Release dated December 20, 1999: "The companies estimate the annual impact of the revenue and cost synergies on operating income will be between US $500-$600 million to be realized about evenly over the first three years after the close of the transaction.

The Board should be congratulated for recognizing America is at a new crossroads. We need a strong, viable rail transportation system to move goods, people and for a strong national defense system. Like any other business, railroads need to earn a fair dividend for its shareholders. Railroads can do this in the same manner that is prevalent in virtually all other sectors of the free market economy – through competition, in both service levels and rates. Competition is the proven foundation for ensuring our transportation system remains financially healthy and responsive to the needs of America's manufacturers and consumers. Further consolidation in the rail industry must be analyzed much more differently than the past to insure that every shipper is afforded safe, operationally feasible, and competitive service.

Thank you for the opportunity to present our views.

Respectfully submitted,

Richard E. Kerth

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